Statement
of
David Coit

President
North Atlantic Capital
&
Immediate Past Chairman
National Association
of
Small Business Investment Companies

Before The

United States Senate
Committee on Small Business & Entrepreneurship

February 17, 2005

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Madam Chair, Senator Kerry, members of the Committee:

It is an honor to testify on behalf of the National Association of Small Business Investment Companies regarding the Administration's FY 2006 budget proposal for the Small Business Investment Company (SBIC) program. NASBIC is the only professional association dedicated to representing the interests of all licensed SBICs. We hope our views are helpful to the Committee as it considers the issues we will address today.

By way of background, I am President of North Atlantic Capital in Portland, ME and a member of NASBIC's Board of Governors, having served as Chairman of the organization for the 2003-2004 term. At North Atlantic Capital we manage two Participating Security SBICs focused on small businesses requiring capital in the $2 million to $5 million range. We concentrate on businesses located in the Northeast. A good example of one of our investments is Diamond Phoenix Corporation of Lewiston, ME, a leader in providing integrated material handling equipment, software, and control technology for order fulfillment systems. We first invested in the company in 1998 and have invested approximately $4.0 million over five years. I am pleased to say that our investments have been instrumental in helping the company grow to its current size—120 employees—and to weather the recent recession. Diamond Phoenix has eight offices in eight different states as well as an office in London, England.

With that introduction, I will turn to issues related to the Administration's FY 2006 budget proposal. I will summarize my remarks, but ask that my full testimony be included in the record.

<u>The Administration's Budget Proposal</u>

1. We are happy to see the Administration continue its strong support of the Debenture program at the $3.0 billion level. As you know, Debenture SBICs primarily make subordinated loans to small businesses with sufficient cash flow to cover the interest payments. The subordinated nature of the loans makes them an important part of the balance sheet insofar as attracting senior bank debt that is so important for business operations.

   While $500 million less than the authorized level for FY 2006, the amount should be sufficient to meet the projected demand for new Debenture leverage during that year. We are also pleased to note that the FY 2006 interest rate adjustment required to maintain a zero subsidy rate for appropriation purposes is virtually unchanged, increasing by less than seven one hundredths of one percent.

2. We are very disappointed that the Administration failed to propose any new Participating Security leverage in FY 2006. As you may remember, the Administration had requested a $4.0 billion program for this year (FY 2005) if the program could be restructured in a way to produce a "zero" subsidy rate for appropriation purposes. Unfortunately, we were unable to come to an agreement with the Administration last year—despite the best efforts of this committee—as to how that restructuring should be accomplished. We treat it as an open issue that we hope will be resolved through further negotiation. However, the budget proposal indicates that the Administration wants to close negotiations altogether. We are not certain why that is the case. Clearly the need for equity capital of the type provided U.S.

small businesses by Participating Security SBICs can not have fallen from the $4.0 billion proposed by the Administration last year to the $0 proposed this year. Nor can it be that the industry is trying to spend scarce government resources: we acknowledge program losses under the current structure—even if a substantial percentage of those losses can be attributed to the recent recession—and we agree that the program must be restructured to run at a true zero subsidy rate requiring no appropriation and no program wide losses that would increase the deficit. We hope that the Administration will reconsider its position during the course of the next few months so that, collaboratively, we can revive this segment of the SBIC program—the segment that provides more than half of all SBIC investments annually.

3. The Administration's refusal to ask for any new Participating Security leverage in FY 2006 has two major consequences, both negative. First, it continues the break in the pipeline of new funds that we are experiencing this year. Participating Security funds, like most venture funds, are formed as 10-year partnerships that make original investments during the first five years and then support those investments with follow-on rounds over the last five years. If new funds are not being formed every year, the capital available to small businesses that have not already received some will dry up quickly. And it is not easy to turn the flow back on quickly. It can take as long as one and one half to two years for a management team to both raise the capital and go through the SBA licensing process. Further, once experienced management teams leave the program, they are unlikely to return in the future. Thus, failure to "fix" the problem will result in less money for small business and fewer experienced management teams to call upon to run the program if the government tries to reinstate the program sometime in the future.

4. The second and equally negative consequence of the Administration's proposal is its abandonment of existing Participating Security SBICs that will need leverage in FY 2006 to operate in accordance with the business plans that SBA approved in the licensing process. Although Participating Security SBICs hold over $5.0 billion in commitments as a group, individual Participating Security SBICs in good standing do not hold commitments sufficient to meet their leverage requirements as approved by SBA in the licensing process. Based on a survey of all Participating Security SBICs, NASBIC estimates this requirement to equal approximately $80 million per year for the years FY 2006 through FY 2010. If unable to draw the leverage when needed, the effected funds will have less diverse portfolios (increasing risk of fund failure) and less money to invest in existing portfolio companies (increasing risk of failure for the very companies the program is designed to support). Failure to solve this problem will constitute a breach of the implicit promise made in the licensing process that leverage sufficient to fund approved businesses plans would be available so long as those funds remained in regulatory compliance. We look forward to working with the Committee this year to determine how the problem might be addressed without the requirement for a substantial appropriation.

5. We pose the following two questions with respect to the future of the Participating Security program. First, is there a need for the program and the equity capital it provides to U.S. small businesses not generally supported by non-SBIC venture funds—whether with respect to size of investment required, or the industry of which the small business is a part, or its geographic location? Second, is there a structure that can be developed that will produce the

desired zero subsidy rate and still keep the program attractive to private investors who must lead with their capital commitments? We think the answer to both questions is “yes.”

With respect to the first question, we hope to provide the Committee with a report by the end of March from the Amos Tuck School of Business Administration at Dartmouth College that we believe will be persuasive with respect to the “capital gap” faced by U.S. small businesses. We hope that the Committee will hold a hearing at that time to consider the very important question of the “need” for the Participating Security program. In addition to the report, we would be happy to suggest the names of several small business entrepreneurs who would be happy to testify concerning the importance of the program for their businesses.

With respect to the second question, we are hard at work designing a new proposed economic structure that would apply to Participating Security funds licensed after the date of its enactment. We would like to work collaboratively with the Administration, but if that is not to be, we will create the new model on our own. We will submit the new model to the Committee as soon as it is ready and, at that time, ask the Committee to consider its merits and request a scoring of the proposed structure for subsidy rate purposes.

6. In conclusion, I refer you to three documents attached to my testimony. The first is the September 9, 2004 letter from the National Venture Capital Association to the President outlining the unique and important role played by the Participating Security program in the universe of private equity. The second is a Participating Security program impact statement prepared by NASBIC that addresses many issues of importance to this Committee. It has been updated to include investments made thus far in FY 2005. The third is an example of data available on the “Equity Gap” faced by U.S. small businesses. We believe that the facts set forth in these documents, to be supplemented by others and validated by the Tuck School report provide a strong foundation that supports the continuing need for the Participating Security program. We look forward to working with the Committee during the months ahead to restructure the program in a manner that will meet that small business need while at the same time running at a true zero subsidy rate based on reasonable economic assumptions.

Thank you for your consideration of our views regarding the Administration’s FY 2006 budget proposal for the SBIC program. I would be pleased to answer any questions you may have concerning those views on or regarding any other issues having to do with the SBIC program.

NVCA
National Venture Capital Association

September 9, 2004

President George W. Bush
1600 Pennsylvania Avenue, NW
Washington, DC 20500

Dear Mr. President:

We have recently learned that there is now a debate within the Administration concerning the economic justification or "need" for SBA's Participating Security SBIC program. NVCA believes strongly that this program fills a void which non-SBIC venture funds are unable to fill. We request that our views be taken into consideration when you formulate the Administration's final position on this issue.

NVCA is the only organization that represents the overall venture capital and private equity industries in the U.S. As such, we believe NVCA is uniquely qualified to address the "need" question relative to the SBIC program. As part of our mission we track the flows of venture capital throughout the country on an quarterly basis and publish our findings so that government and industry leaders can better understand and appreciate the critical role venture capital plays in U.S. job creation and economic growth. In addition, reports such as, "Venture Impact 2004," issued July 20, 2004 demonstrate that venture capital continues to play a critical role in encouraging growth of the U.S. economy and contributing to job growth and technical progress.

With that brief background, let me turn to the three reasons we believe there is a role that the SBIC program fills within the private equity universe for the Participating Security SBIC program:

1. First, Participating Security funds make equity investments in smaller increments than do the large majority of non-SBIC venture funds. This is of critical importance to very small companies, particularly those not in high-technology industries, which require equity financing rounds in the $1.0- to $5.0 million range. That range of investing is generally not attractive to major non-SBIC venture funds, but one that is critical to help grow the business to a level that will eventually attract the interest of non-SBIC funds.

2. Second, SBICs, including Participating Security funds, make investments in areas of the country that are generally not served by the large majority of non-SBIC venture funds. For example, companies in California and Massachusetts received 52% of all venture capital invested during the period FY 1994 – FY 2002. During the same period, SBIC's invested 71% of their capital in companies outside of California and Massachusetts. Since there is no way to tell in advance which small companies will grow to tomorrow's large public success stories or simply important regional employers, nurturing companies in all segments of the country is important.

3. Third, SBIC's support a much more diverse segment of small businesses than do non-SBIC venture funds. In recent years, non-SBIC funds have concentrated their

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investments in the NAIC fast growing critical sectors of "Communications & Computers" and "Life Sciences." In contrast, SBIC's have invested approximately 50% of their funds in NAIC sectors "Manufacturing" and "Consumer Related." While there is overlap, it is clear that the SBIC program addresses the capital needs of many small businesses that are in industry sectors generally not attractive to non-SBIC funds.

In conclusion, the Participating Security program is a small but important part of America's overall capital structure. We urge the Administration to support continuation of the program and to work with all the program's stakeholders to secure the legislation necessary to achieve that result.

Thank you for your consideration of our views. We are available at your convenience to discuss the points made above or to address other issues the Administration believes are relevant to make a final decision on the future of the Participating Security SBIC program.

Sincerely,

Mark Heesen
President

cc: Hector Barreto
Joshua Bolten
Daniel Heath
Hon. Donald Manzullo
Hon. Olympia Snowe

NASBIC
America's Small Business Partners

The Impact Of The Participating Security SBIC Program

- Participating Security SBICs have invested \$8.9 billion since the program's 1994 inception.

- Participating Security SBICs currently account for over 50% of all SBIC investments and are a major source of seed capital in the U.S. According to SBA, SBICs provided 64% of seed capital invested by institutional investors during FY'94 – FY'02.

- Approximately 35% (\$3.1 billion) of \$8.9 billion in Participating Security investments from FY'94 to date have been made in small U.S. manufacturing companies.

- Participating Security SBICs were the most reliable source of equity capital for U.S. small businesses during the recession. All venture capital investments fell 83% between 2000 and 2003 according to Venture Economics. Participating Security investments during the same period—a total of \$5.25 billion—fell just 23%.

- Raising equity capital in the SBIC target range of \$1.0- to \$5.0 million is the most difficult for a small company to secure. The average VC "deal" size is between \$7.0- and \$10.0 million. The "Equity Gap" is real and an impediment to small business job creation.

- Non-SBIC venture capital is concentrated in a very few states. For FY'94 – FY'02, companies in California and Massachusetts received 52% of all venture capital. During the same period, SBIC's invested only 29% of their capital in companies in those states.

- The \$8.9 billion in Participating Security investments since 1994 have led to the creation of an estimated 240,000 new jobs and \$41 billion in portfolio company revenue. Sixty-two percent of that growth—148,000 jobs and \$25.4 billion in portfolio company revenue—occurred during the recession recovery period of from the start of FY 2001 to date.

  (Estimate based on a 2001 National Venture Capital Association study that found that one sustainable job is created for every \$36,000 in venture capital invested in a small business and every \$1.00 in venture capital leads to \$4.75 in portfolio company revenue.)

- Participating Security investments have resulted in approximately \$8.7 billion in employee compensation per year.

  (Estimate based on 2001 average U.S. compensation of \$36,214 per full-time job.)

- Participating Security investments have resulted in approximately \$1.36 billion in income and social insurance taxes per year paid to the federal government.

  (Estimate based on an August 2003 Congressional Budget Office report that found the effective federal tax rate for middle quintile households in 2000 to be approximately 16%. The average effective tax rate for all quintiles was approximately 23%.)

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The Small Business Equity Gap

The following is taken from a November 2, 2004 article by Daniel Sandler of the University of Western Ontario titled “Tax Incentives and Angel Capital: Federal & State Incentive Review and Commentary.”

Of the 500 fastest growing companies in the United States (the "Inc. 500") in 2002 (measured by revenue growth over five years), 41 percent started business with $10,000 or less and 14 percent started with less than $1,000. In contrast, only 22 percent started with more than $100,000. Only 2 percent of the 2002 Inc. 500 list received seed capital from venture capitalists.

The formal venture capital industry, comprised of professionally managed venture capital funds, tends to reject small deals because they are simply not worth the costs associated with their assessment and monitoring. Furthermore, as the size of private venture capital funds has increased, the size of the average investment per round of financing and, perhaps more important, the size of the average first-round investment, has increased significantly. Table 1.1 shows the size of first-round financing by industry group and overall in the formal venture capital industry over the period 1980 to 2003. ***While there has been some softening in recent years, the average first-round investment in the formal venture capital industry remains significant and has exacerbated the equity gap at the earliest stages of a business's development.*** [Emphasis added] As a consequence, government venture capital policy and programs often focus on angel financing generally as well as seed and start-up financing because early-stage financing has the potential to generate the greatest social returns through job creation and product innovation and because financing at these stages is not adequately addressed by the formal venture capital industry.

Table 1.1
Average First Round Investment 1980-2003

Industry Sector	**Average First Round Investment ($millions)**											
	1980	1985	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003
Communications	0.7	1.9	4.2	5.0	3.8	4.1	5.9	9.7	12.3	7.9	5.7	4.4
Computer Hardware and Services	1.1	1.5	2.8	3.0	3.9	3.5	4.4	7.3	8.5	5.7	6.6	4.9
Computer Software	0.9	1.3	2.1	2.6	2.7	3.1	3.6	4.8	7.0	5.6	4.1	4.4
Retailing and Media	0.6	2.2	3.3	4.8	4.8	3.6	5.5	6.1	7.8	4.4	4.2	6.2
Biotechnology	1.1	1.2	1.0	2.7	3.5	4.2	3.5	4.9	7.4	7.9	6.8	6.5
Healthcare Related	1.2	1.2	2.2	4.9	3.3	3.8	4.0	4.5	5.9	4.3	6.0	4.4
Semiconductors and Electronics	1.1	1.6	2.5	2.9	4.5	4.1	5.0	6.0	9.4	7.4	6.3	6.7
Industrial/Energy	1.4	1.5	1.9	6.2	3.8	4.0	10.2	9.7	8.9	6.4	7.8	6.0
Business/Financial	0.6	2.8	4.3	4.4	6.1	3.5	5.7	6.5	8.3	5.8	4.5	7.6
Overall	**1.1**	**1.7**	**2.5**	**4.1**	**3.8**	**3.7**	**5.1**	**6.5**	**8.6**	**6.3**	**5.5**	**5.3**

Source: Thomson Venture Economics, 2004 National Venture Capital Association Yearbook (Arlington, VA and New York, NY: Thomson Venture Economics, 2004), Figures 4.02, 4.11, 4.20, 4.29, 4.38, 4.47, 4.56, 4.65 and 4.74 for industry sectors; the overall figure is extrapolated from Figures 3.13 and 3.15.

Council on Competitiveness National Innovation Initiative Report
December 2004

The Council on Competitiveness (www.compete.org) was established in 1986 to address issues associated with the loss by the United States of its preeminent position in the world economy. Of particular concern to the founders was the decline in U.S. leadership in technology development and commercialization and the loss of market share to international competitors. To help meet this challenge, two-dozen industrial, university, and labor leaders joined together to create the Council to serve as a forum for elevating national competitiveness to the forefront of national consciousness. The Council's mission is to set an action agenda that drives economic growth and raises the standard of living for all Americans. The Council describes itself as the only national organization whose membership is comprised exclusively of CEOs, university presidents, and U.S. labor leaders.

In December 2004, the Council issued a report titled "Innovate America." Among the findings of the report related to the availability of risk capital are the following:

1. "Thousands of inventions lie dormant in the hands of universities, research centers and private companies. For those ideas that are pursued commercially, only seven out of every 1,000 business plans receive funding." (Page 33)

2. Entrepreneurs "lack risk capital … [and] regions often lack the institutional … mechanisms to direct existing capital assets to entrepreneurial activities." (Page 35)

3. "Recently, [the "funding gap'] has been widening as VC firms are shifting investments to focus on more mature firms with larger capital needs. Entrepreneurs report difficulty in raising money between $2 million and $5 million." (Page 36)

David M. Coit

David Coit is President of North Atlantic Capital in Portland, Maine. North Atlantic holds two Participating Security Small Business Investment Company (SBIC) licenses issued by the U.S. Small Business Administration and focuses on later-stage small business investment opportunities in the $2.0 million to $5.0 million range. Mr. Coit established North Atlantic Capital in 1986 and serves as the firm's Senior Managing Director.

Prior to forming North Atlantic Capital, Mr. Coit was president of Maine Capital Corporation, an SBIC also located in Portland, Maine. Prior to that, he had worked for six years as a commercial lending officer at the Bank of Boston, where his customers included several of the region's venture capital firms and many venture capital-backed companies.

Mr. Coit has served on the boards of directors of numerous portfolio companies during his 22 years in the private equity business. He has served as the President of the Northeastern Regional Association of Small Business Investment Companies and as Chairman of the National Association of Small Business Investment Companies. In addition, Mr. Coit has served on the board of the New England Venture Capital Association and the boards of several not-for-profit boards—including the Schepens Eye Research Institute (affiliated with Harvard Medical School), the Taft School, the University of Southern Maine Business School, and Bigelow Laboratories.

Mr. Coit graduated from Yale University with a BA in economics and received his MBA from the Harvard Business School. From 1970 to 1972, he served as an officer in the U.S. Navy.